

**TENNESSEE DEPARTMENT OF REVENUE  
LETTER RULING # 05-07**

**WARNING**

**Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This presentation of the ruling in a redacted form is informational only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Department policy**

**SUBJECT**

Application of franchise tax and excise tax to a corporation and its newly created qualified subchapter S subsidiary.

**SCOPE**

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the Department by the taxpayer. The rulings herein are binding upon the Department and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time.

Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

- (A) The taxpayer must not have misstated or omitted material facts involved in the transaction;
- (B) Facts that develop later must not be materially different from the facts upon which the ruling was based;
- (C) The applicable law must not have been changed or amended;
- (D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and
- (E) The taxpayer directly involved must have acted in good faith in relying upon the ruling; and a retroactive revocation of the ruling must inure to the taxpayer's detriment.

**FACTS**

[THE TAXPAYER], is incorporated and domiciled in the [STATE –NOT TENNESSEE] and is engaged in the business of [MANUFACTURING]. For federal income tax purposes, [THE TAXPAYER] has elected to be taxed as a subchapter S corporation. It currently has manufacturing facilities in [STATE – NOT TENNESSEE] and Tennessee.

For various business reasons, [THE TAXPAYER] is considering transferring its Tennessee operations into a wholly owned subsidiary (Newco) that will be incorporated under the laws of the [STATE – NOT TENNESSEE]. [THE TAXPAYER] will then make a qualified subchapter S subsidiary (QSSS) election for Newco. As a result of this election, for federal income tax purposes, Newco will be disregarded as a separate entity and will be taxed as a division of [THE TAXPAYER]. After the transfer, [THE TAXPAYER] (the parent) will not have any property, payroll, or sales in Tennessee and will not be conducting business in Tennessee.

## **ISSUES**

1. For Tennessee franchise tax and excise tax purposes, will Newco be taxed as a separate corporation, even though it is disregarded for federal income tax purposes? If so, will [THE TAXPAYER] be considered taxable in Tennessee solely because of its ownership interest in Newco?
2. If Newco is taxed as a separate entity, is it required to prepare a pro-forma federal income tax return?
3. For purposes of computing the Tennessee franchise tax, if [THE TAXPAYER] (as a separate entity) is taxable in Tennessee, should it report the assets owned by Newco on Schedule G as owned by [THE TAXPAYER]?
4. For purposes of computing the Tennessee excise tax, if [THE TAXPAYER] (as a separate entity) is taxable in Tennessee, should it include the property, payroll, and sales of Newco in the property, payroll, and sales factors of [THE TAXPAYER]?
5. Assuming that there are valid business reasons for [THE TAXPAYER] to establish Newco, and the primary purpose of forming Newco was not the evasion of either federal tax or Tennessee excise tax, under what circumstances would the Department require [THE TAXPAYER] and Newco to file a combined report utilizing combined apportionment factors?

## **RULINGS**

1. Newco will be subject to Tennessee franchise tax and excise tax as a separate entity. [THE TAXPAYER] will not be subject to franchise tax and excise tax solely because of its ownership interest in Newco. However, if [THE TAXPAYER] maintains an active registration as a foreign corporation with the Tennessee Secretary of State, they will be required to file annually and pay the minimum franchise tax (currently \$100).
2. Yes.
3. Not applicable. [THE TAXPAYER] would not be subject to tax in Tennessee solely because of its ownership interest in Newco as described in the facts. If [THE TAXPAYER] were subject to tax, [THE TAXPAYER] would neither include the assets

of Newco on its return nor include the property, payroll, and sales of Newco in their apportionment formula. (See #1 regarding the possible liability for the minimum franchise tax.)

4. Same as # 3.

5. Tenn. Code Ann. §§67-4-2014 and 67-4-2112 authorize the Commissioner to issue a variance in reporting methodology if the standard tax computation, allocation, or apportionment provisions do not fairly represent the extent of the taxpayer's business activity in Tennessee. While it does not appear from the facts presented that a variance would be appropriate in this case, the Commissioner declines to issue a letter ruling on this question because many other facts may be relevant.

### **ANALYSIS**

Tenn. Code Ann. § 67-4-2005 provides that it is a taxable privilege for any person to do business in Tennessee and/or exercise the corporate franchise. Tenn. Code Ann. § 67-4-2004(27) defines "person" to include subchapter S corporations. Tenn. Code Ann. §§ 67-4-2007(e) and 67-4-2106(c) provide that each taxpayer is considered a separate entity (except for unitary groups of financial institutions and certain hospital companies) and must file its Tennessee franchise and excise tax return as a separate entity. Thus, Newco will be taxed, and will need to file returns, as a separate entity. [THE TAXPAYER] would not be subject to franchise tax and excise tax solely because of its ownership interest in Newco.

Tenn. Code Ann. § 67-4-2006(a)(2) provides that for corporations electing federal S corporation status, "net earnings" is defined as federal taxable income calculated as if the corporation had not elected S corporation status, as determined before the operating loss deduction and certain other deductions provided in the Internal Revenue Code. Thus, Newco's Tennessee return would be based on a pro-forma federal return.

[THE TAXPAYER]'s ownership of Newco, does not constitute "doing business in Tennessee" for franchise tax and excise tax purposes. If [THE TAXPAYER] has no other business activities in Tennessee, [THE TAXPAYER] would not be liable for Tennessee franchise tax or excise tax. However if [THE TAXPAYER] maintains an active corporate registration in Tennessee, they would be required to file an annual return and pay the minimum franchise tax. Newco's assets would be reported on Newco's return. If there were other circumstances that required [THE TAXPAYER] to file in Tennessee, [THE TAXPAYER] would not include the assets of Newco on its return nor would it include the property, payroll, and sales of Newco in their apportionment formula.

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APPROVED: Loren. L. Chumley  
Commissioner

DATE: 1/31/05